Internal Revenue Service

memorandum

CC:TL:Br2
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date: APR 25 1988

to: District Counsel, Hartford CC:HAR

from: Director, Tax Litigation Division CC:TL

subject: [redacted]

Your request for technical advice dated February 19, 1988, was received and assigned March 21, 1988. As the advice concerns a case on the [redacted] trial calendar, we are giving expedited consideration.

ISSUE

Whether the taxpayer should have made a negative adjustment, pursuant to Treas. Reg. § 1.1502-32(b)(2)(iii),1/ in its basis in [redacted] stock upon a deemed dividend, pursuant to Treas. Reg. § 1.1502-32(f)(2), of earnings and profits transferred to [redacted], pursuant to section 381(c).

CONCLUSION

No negative adjustment is required. The issue should be conceded.

FACTS

The present controversy arises out of an acquisitive reorganization in the form of a forward triangular merger, pursuant to sections 368(a)(1)(A) and 368(a)(2)(D).2/ On [redacted], the taxpayer, [redacted] incorporated [redacted] as a wholly-owned subsidiary. Effective [redacted], a target corporation merged into [redacted] and the target corporation shareholders received [redacted] stock. The Service has stipulated for the purposes of this case that [redacted]'s basis in [redacted] stock was stepped-up in a manner

1/ Unless otherwise noted, all references to Treasury Regulations are to regulations in effect during the tax years at issue.

2/ All code references are to the Internal Revenue Code of 1954. Relevant amendments will be noted.

equivalent to what is required by Proposed Treas. Reg. § 1.358-6 (1981), so that the basis in the stock would reflect the inclusion of the target's assets and liabilities in [redacted] assets and liabilities. The step-up in basis would also reflect the earnings and profits that were transferred from the target to [redacted], pursuant to section 381(c).

[redacted] and [redacted] filed Consolidated Returns throughout the years in question beginning in the year [redacted] was incorporated. Section 1502.

[redacted], pursuant to Treas. Reg. § 1.1502-32(f)(2), filed a timely deemed dividend election in order to have [redacted] make a distribution of its accumulated earnings and profits, as of [redacted]. The effect of the deemed dividend was that on [redacted] fictitiously distributed its earnings and profits to [redacted] and [redacted] fictitiously contributed the earnings and profits back to [redacted] as a capital contribution. The net effect of the deemed dividend was to increase [redacted]'s basis in [redacted] stock by $[redacted]; which is the amount of the earnings and profits that were transferred from the target corporation to [redacted] in the forward triangular merger.3/

The District Counsel's position is that [redacted] has increased its basis in [redacted] stock twice for the same earnings and profits accumulated by the target corporation; once by the forward triangular merger and once by the deemed dividend. Thus, when [redacted] sold all of its stock in [redacted], in [redacted] its basis was artificially inflated.

3/ A distribution out of earnings and profits of a subsidiary accumulated in prior consolidated return years beginning after December 31, 1965 or accumulated in preaffiliation years of the subsidiary results in a decrease in the parent's basis in the stock of the subsidiary, pursuant to Treas. Reg. § 1.1502-32(b)(2)(iii). And a capital contribution by the parent back to the subsidiary results in an increase in the parent's basis in the subsidiary's stock, pursuant to Treas. Reg. § 1118-1. Thus, the net effect of the two transactions is to leave the parent's basis in the stock of the subsidiary unchanged. However, pursuant to Treas. Reg. § 1.1502-32(d)(6), the earnings and profits transferred by the target to [redacted] were not accumulated in prior consolidated return years nor accumulated in preaffiliation years so that upon the fictious distribution there was no negative adjustment, pursuant to Treas. Reg. § 1.1502-32(b)(2)(iii). But, on [redacted]'s fictitious contribution of the earnings and profits back to [redacted], [redacted]'s basis in [redacted] stock was increased by $[redacted], pursuant to Treas. Reg. § 1.118-1.

According to District Counsel, the Service is conceding that the deemed dividend election was proper, but that [redacted] should have made a negative adjustment to its basis, pursuant to Treas. Reg. § 1.1502-32(b)(2)(iii), in order to neutralize the effect of the deemed dividend. The District Counsel contends that Treas. Reg. § 1.1502-32(d)(6) should not apply to exempt the earnings and profits, transferred from the target corporation to [redacted], from the negative adjustment.

DISCUSSION

When an affiliated group of corporations files consolidated returns, generally, the tax attributes of each member -- taxable income, net operating losses, capital gains and losses, etcetera -- are combined with, and utilized against, the tax attributes of the other members, so that the group as a whole bears the benefits and burdens of each member's tax life. If a member of the group sells its holdings in a subsidiary member, and if the seller's basis in the subsidiary's stock does not reflect the gains and losses incurred by that subsidiary while it was a member of the affiliated group, then the seller would again recognized the same benefits or burdens of the subsidiary's life. For example, if the subsidiary had made money the selling price of the stock would be above the seller's basis and the seller would recognized income that was already recognized by the seller when the taxable income of the subsidiary was included in previous consolidated returns. If the subsidiary had lost money, the selling price of the subsidiary's stock would be below the seller's basis and the seller would recognize a loss that was already recognized when the subsidiary included its net operating losses in previous consolidated returns. See Garvey, Inc. v. United States, 83-1 U.S. ¶ 9163, F.N. 9 (Cl. Ct.).

The investment adjustment provision, Treas. Reg. § 1.1502-32, was promulgated to solve this problem. Pursuant to the regulation, the basis of a subsidiary member's stock in the hands of another member floats up and down depending on whether the subsidiary makes money or loses money and whether the subsidiary distributes its earnings or profits. Generally, the basis of a subsidiary member's stock is increased by the undistributed current earnings and profits of the subsidiary, and decreased by current deficits in the earnings and profits of the subsidiary and distributions out of the earnings and profits of the subsidiary.

Pursuant to Treas. Reg. § 1.1502-32(b)(2)(iii)(a) & (b) distributions that would decrease a member's basis in a subsidiary's stock were limited to earnings and profits that were accumulated in prior consolidated return years beginning after

December 31, 1965[4] i.e., earnings and profits that were already shared by the affiliated group in prior consolidated tax returns; and earnings and profits accumulated in preaffiliation years of the subsidiary. It was presumed that earnings and profits from preaffiliation years would be reflected in the purchase price, and thus, the basis of the subsidiary's stock.

The deemed dividend election of Treas. Reg. § 1.1502-32(f)(2) is a rule which gives an affiliated group, who filed consolidated returns before the effective date of Treas. Reg. § 1.1502-32, the benefit of the investment adjustment provision. By making a deemed dividend election, the basis in a subsidiary's stock held by another member is stepped up by the amount of earnings and profits accumulated by the subsidiary before January 1, 1966 while the subsidiary was a member of the affiliated group.[5] Theoretically, the amount of the step-up in basis would equal the income or loss already realized by the group before 1966, so that upon the disposition of the subsidiary's stock the member holding the stock would not recognize the same gain or loss recognized in previous consolidated returns.

Pursuant to Treas. Reg. § 1.1502-32(d)(6) (before it was amended in 1979) a parent member, who owned the stock of a subsidiary member, could avoid reducing its basis on a dividend distribution by the subsidiary, if the distribution was out of earnings and profits accumulated by a target corporation and transferred to the subsidiary member pursuant to section 381(c). See Footnote 3, supra. Although there is no reference in T.D. 6909 to the drafter's rationale the reasoning behind Treas. Reg. § 1.1502(d)(6) appears to have been based on the proposition that if the parent member's basis in a subsidiary's stock is not stepped up to reflect the target's earnings and profits transferred to the subsidiary, there is no reason to reduce the parent's basis on a dividend distribution. Apparently, the drafters of the regulation either did not contemplate the section's application to triangular mergers or thought that even

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[4] January 1, 1966 was the effective date for Treas. Reg. § 1.1502-32.

[5] Pursuant to a deemed dividend, upon the fictitious distribution of the subsidiary's earnings and profits, earnings and profits not accumulated in prior consolidated years beginning after December 31, 1965 nor accumulated in preaffiliation years do not cause a decrease in the basis of the subsidiary's stock held by another member of the group. Upon the fictitious contribution back to the subsidiary of the earnings and profits, the member's basis in the subsidiary's stock is increased pursuant to Treas. Reg. § 1.118-1. See Footnote 3, supra.

in triangular mergers the parent's basis in its subsidiary's stock is not stepped up.

The 1968 and 1971 proposed amendments to Treas. Reg. § 1.1502-32 were consistent with the above proposition. The proposed amendments would have treated a type B reorganization or a section 351 transaction the same way a type A or C reorganization was treated under Treas. Reg. § 1.1502-32(d)(6). In general, the proposed amendments would have allowed a parent member to avoid reducing its basis in a subsidiary member's stock upon a distribution out of earnings and profits accumulated by the subsidiary before it was owned by the parent, if the parent received a carryover basis in the subsidiary's stock.

However, in 1972 the Service made a complete reversal of its position in regards to earnings and profits that were either transferred to a subsidiary member pursuant to section 381(c) or were not reflected in the parent member's basis because the parent received a carryover basis. A memorandum, dated April 4, 1972, in T.D. 7246 (for the 1968, 1971 proposed amendments) from the Commissioner to the Assistant Secretary of the Treasury states why the specific amendments were being withdrawn: "... we have concluded that it would violate the basis carryover rule of section 362(a) and (b) of the Code. The adjustment to the basis of the stock under § 1.1502-32 should apply to the basis in the stock determined under the Code, whether that basis is cost or is a carryover basis under section 362(a) or (b)."

The reasoning underlying the Services reversal is unclear but it may be the same reasoning the court used in Garvey, Inc. v. United States, 83-1 U.S.T.C. ¶ 9163 (Cl. Ct.). In Garvey the court held against a taxpayer who received a carryover basis in the stock of a subsidiary. The taxpayer, who filed consolidated returns, had not reduced its basis in the subsidiary member's stock upon an actual distribution by the subsidiary out of earnings and profits accumulated in preaffiliation years. The taxpayer argued that if it reduced its basis it would recognize a "phantom gain" on the sale of the subsidiary's stock. The court disagreed stating: "The 'phantom gain' is not the reduction required by the regulation [Treas. Reg. § 1.1502-32(b)(2)(iii)(B)] but the reduction required by the Statute, i.e., § 362(b)" Garvey, at 86,258. (For a further discussion, see Garvey, at 86,258).

At about the same time, the Service also decided to amend Treas. Reg. § 1.1502-32(d)(6) and Treas. Reg. § 1.1502-32(b)(2)(iii) so that upon the distribution of earnings and profits accumulated by a target and transferred to a subsidiary pursuant to section 381(c), a negative adjustment would be required. The amendments solve the problem that is at issue here

by, in effect, repealing the old Treas. Reg. § 1.1502-32(d)(6). The amendments were published in the 1973 proposed amendments to Treas. Reg. § 1.1502-32, 38 Fed. Reg. 774 (T.D. 7637), and were finally adopted on August 9, 1979.

The amended Treas. Reg. § 1.1502-32(d)(6) draws a distinction between distributions made before August 9, 1979 and distributions made after that date. The new regulation states that pre-August 9, 1979 distributions out of earnings and profits received by a subsidiary member pursuant to section 381(c) do not require a negative adjustment, but that post-August 9, 1979 distributions do require a negative adjustment. Considering the fact that the Service knew of the instant issue when it promulgated the regulation (see below) the regulation is, in effect, conceding the instant issue by expressly making the amendments application prospective.

The reasoning behind the amendments adopted in 1979 appears to be to solve the problem at issue here. In an article published in November 1973 by the late James F. Drings, who was then Director of the Legislation and Regulations Division, he notes the tax avoidance scheme that is at issue here and states that the new regulations (adopted 1979) are aimed at eliminating this problem. Dring, How the Consolidated Reg. Amendments Clarify the Investment Adjustment Rules, 39 J. Tax 266, 668 (1973).

G.C.M. 37577, I-450-76 (June 20, 1978), and two private letter rulings, which are based on the G.C.M. (P.L.R. 7931007 (August 3, 1979) and P.L.R. 8320002 (May 20, 1983)) try to solve the problem at issue here, for taxable years before the effective date of the 1979 amendments, by making a distinction between an actual dividend of earnings and profits transferred to a subsidiary member pursuant to section 381(c) and a deemed dividend of the same earnings and profits. In essence, the G.C.M. argues that an actual dividend has an economic reality because assets actually leave the subsidiary, but a deemed dividend used in conjunction with Treas. Reg. § 1.1502-32(d)(6) is merely paper transaction which has as its only purpose tax avoidance. The G.C.M. would bar the application of Treas. Reg. § 1.1502-32(d)(6) to a deemed dividend. However, the distinction the G.C.M. drawing between an actual dividend and a deemed dividend is illusory because in either case Treas. Reg. § 1.1502-32(d)(6) allows the parent to take a basis in the subsidiary's stock that is greater than what the basis would be if the Treas. Reg. § 1.1502-32(d)(6) did not apply. An example will illustrate the flaw in the G.C.M. and private letter rulings.

Assume a parent's basis in its subsidiary's stock is equal to the value of the subsidiary's assets. Upon an actual dividend

distribution by the subsidiary to the parent of earnings and profits transferred to the subsidiary from a target pursuant to section 381(c), Treas. Reg. § 1.1502-32(d)(6) prevents a negative adjustment to the parent's basis. However, the fair market value of the subsidiary is reduced by the amount of the dividend. Thus, upon the sale of the subsidiary's stock, the parent recognizes a loss equal to the amount of the dividend. If instead the parent and subsidiary had elected to make a deemed dividend, the fictitious distribution of the earnings and profits transferred to the subsidiary pursuant to section 381(c) does not reduce the parent's basis, but on the fictitious contribution back to the subsidiary, the parent's basis in the subsidiary's stock is increased by the amount of the earnings and profits, pursuant to Treas. Reg. § 1.118-1. See footnote 3, supra. The fair market value of the subsidiary after the deemed dividend is the same as before the deemed dividend, because no assets have left the subsidiary, but the parents basis in the subsidiary's stock has been stepped-up by the amount of the deemed dividend. Thus, upon the sale of the subsidiary's stock, the parent recognizes a loss, which is again equal to the amount of the dividend.

As shown above to bar the application of Treas. Reg. § 1.1502-32(d)(6) to a deemed dividend but not to an actual dividend is irrational because the same result occurs in either case. Why block the front door while leaving the back door wide open.

Because the argument in G.C.M. 37577 is flawed, the Commissioner would have to rely on an alternative theory if he were to argue that the taxpayer should have made a negative adjustment upon the deemed dividend. One argument is that a deemed dividend, pursuant to Treas. Reg. § 1.1502-32(f)(2), was never intended by the promulgators of the provision to be used in regards to earnings and profits transferred to a subsidiary pursuant to section 381(c); such earnings and profits being excluded from a negative adjustment upon distribution pursuant to Treas. Reg. § 1.1502-32(d)(6). However, this argument is flawed in exactly the same way G.C.M. 37577 is flawed, because it makes an illusory distinction between actual and deemed dividends.

The only legitimate argument the Service can make is that Treas. Reg. § 1.1502-32(d)(6) cannot be applied to either an actual dividend or a deemed dividend. However, this is the same as arguing that the provision should be given no effect whatsoever. To argue that Treas. Reg. § 1.1502-32(d)(6) should not be given effect would conflict with the express language of the amended Treas. Reg. § 1.1502-32(d)(6), which gives the amendments only prospective application (see discussion, supra).

In addition, this alternative argument would run directly into Woods Investment Company v. Commissioner, 85 T.C. 274 (1985). There the court held, in effect, that if the Commissioner did not like the result mandated by his regulations he should have them amended. As was the case in Woods Investment Co. the regulations at issue here are clear, and it was not until 1979 that the Service amended its regulations.

The Service's position here is distinguishable from Wyman-Gordon Co. and Rome Industries, Inc. v. Commissioner, 89 T.C. 207 (1987), because in Wyman-Gordon relevent case law caused two parts of the regulations to conflict with each other, so that there was no clear answer. As stated above, in the instant case the regulations are clear; rather the Service just does not like the result.

RECOMMENDATION

For the following reasons the instant issue should be conceded. First, it is clear, based on the amended regulation, that the 1979 amendments to Treas. Reg. § 1.1502-32(d)(6) (that solve the problem at issue) are only effective prospectively and have no bearing on the taxpayer's case because the taxable years at issue here are pre-1979. Second, the language of the amended Treas. Reg. § 1.1502-32(d)(6) gives the impression that the Service is conceding the issue for pre-1979 years. Third, G.C.M. 37577 is of little help to the Service because, as shown above, the distinction it draws between an actual dividend and a deemed dividend is illusory. Fourth, the Service would have difficulty distinguishing Woods Investment Company if it tried to argue that the taxpayer should make a negative adjustment in its basis upon the deemed dividend in the face of the clear language of the regulations instructing otherwise. Fifth, Wyman-Gordon is distinguishable and does not support the Service's position.

MARLENE GROSS

By: Alfred C. Bishop, Jr.
ALFRED C. BISHOP, JR.
Chief, Branch No. 2
Tax Litigation Division